APPENDIX.

United States Court of Appeals

FOR THE EIGHTH CIRCUIT

No. 15,425

Omaha Public Power District, a public corporation and political subdivision of the State of Nebraska, Western Iowa Power Company, a corporation, Iowa Power and Light Company, a corporation, and Omaha Electric Committee, Inc., a corporation,

Appellants,

vs.

George W. O'Malley, Collector of Internal Revenue for the United States Internal Revenue Collection District of Nebraska,

Appellee.

Appeal from the United States District Court for the District of Nebraska.

[May 3, 1956.]

Reece A. Gardner (Raymond M. Crossman, Thomas C. Quinlan, G. Lee Burns; Brown, Crossman, West, Bar-

ton and Quinlan; and Stinson, Mag, Thomson, McEvers & Fizzell were with him on the brief), for Appellants.

Karl Schmeidler, Attorney, Department of Justice (H. Brian Holland, Assistant Attorney General; Ellis N. Slack and Robert N. Anderson, Attorneys; and Donald R. Ross, United States Attorney, were with him on the brief), for Appellee.

Before SANBORN, WOODROUGH, and VAN OOSTERHOUT, Circuit Judges.

VAN OOSTERHOUT, Circuit Judge.

This is an appeal from the judgment of the District Court dismissing plaintiffs' (appellants) complaint for recovery of federal income tax imposed upon income of the Western Iowa Power Company, hereinafter called Western Iowa. We will refer to the parties as plaintiffs and defendant. The principal plaintiff is the Omaha Public Power District, a public corporation and political subdivision of the State of Nebraska, hereinafter called Omaha District, which corporation is the owner of the rights of all of the plaintiffs to any recovery in this action. The question which arises upon this appeal is whether the income earned, reported, and paid by Western Iowa for the period from December 2, 1946, to May 14, 1949, was exempt from federal income tax under section 116(d) of the Internal Revenue Code of 1939 as income derived from a public utility and accruing to a political subdivision of a State.

The trial court adopted the facts stipulated by the parties as its findings of fact. There is no factual dis-

pute. Omaha District is a political subdivision of the State of Nebraska. The income of Western Iowa was derived from a public utility. The stipulation sets out the long and complicated history of the creation of Omaha District and its acquisition of property. This history is set out in detail in *Omaha Public Power District* v. *O'Malley*, 114 F. Supp. 3, affirmed 216 F. 2d 764. For our purposes here it is sufficient to state that, pending enabling legislation and the legal test thereof, some public-spirited Omaha citizens, interested in placing the Omaha utilities under local public ownership, organized Omaha Electric Committee, Inc., a nonprofit Nebraska corporation. Omaha Electric Committee acquired all of the stock of the Nebraska Power Company which furnishes the electric service to the Omaha territory, and also to an adjoining section of Iowa. The purpose of Omaha Electric Committee was to act as a medium by which the electric system of Nebraska Power Company could be acquired and transferred to a political subdivision of the State of Nebraska. Omaha Electric Committee was bound by an agreement to transfer without profit the properties it acquired to Omaha District, and at all times recognized this obligation. Omaha District was organized in 1945, and a decree upholding its legality was entered in 1946.

The only way the Omaha utilities could be advantageously acquired was by the purchase of all of the stock of Nebraska Power Company. Since Nebraska Power Company owned some Iowa electric utilities these necessarily were included in the transaction. Because of the decision of the Nebraska Supreme Court in *State* v. *Consumers Power District*, 143 Neb. 753, 10 N.W. 2d 784, and the doubt that existed whether Omaha District could lawfully operate the Iowa utilities, Omaha Electric Committee and Omaha District agreed that Western Iowa, an Iowa cor-

poration for pecuniary profit, would be organized to acquire and operate the utilities located in Iowa. Such agreement also contemplated that the Iowa assets would be sold as soon as practicable and that all proceeds of sale would be paid to or used for the benefit of Omaha District. Western Iowa operated the Iowa utilities from December 2, 1946, until May 14, 1949, and during said period reported its income for federal income tax purposes and paid the income taxes due. On May 14, 1949, Omaha Electric Committee completed the sale of all stock and bonds of Western Iowa to Iowa Power and Light Co. As part of said transaction Iowa Power and Light Co. agreed that any income tax refund that might be due in this action would be the property of Omaha District. Omaha Electric Committee recognized and carried out its obligation to transfer to Omaha District the Nebraska utilities, and also paid to or for the benefit of Omaha District the proceeds received from the sale of the Iowa properties. No dividends were paid by Western Iowa during the period involved in this action.

The trial court had jurisdiction. 28 U.S.C., § 1341. Claims for refund were filed and disallowed. All conditions precedent to the institution of this action as required by 26 U.S.C., § 3772, 1952 Edition, have been met. This court has jurisdiction. 28 U.S.C., § 1291.

Plaintiffs contend that the income of Western Iowa for the period here involved was exempt under section 116(d) of the Internal Revenue Code of 1939, which excludes from gross income, "Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory * * *."

The trial court correctly states that the sole issue involved in this case is the question of whether the income from Western Iowa accrued to the Omaha District. Plaintiffs contend that the word "accruing" in section 116(d) means "inuring," and that such interpretation is supported by legislative history, treasury interpretations, and by *City of Galveston* v. *United States*, Ct.Cls., 10 F. Supp. 810; and *Jamestown & Newport Ferry Co.* v. *Commissioner*, 1 Cir., 41 F. 2d 920. The trial court rejected plaintiffs' contention, relying principally upon *Bear Gulch Water Co.* v. *Commissioner*, 9 Cir., 116 F. 2d 975.

The *Bear Gulch Water Co.* case fully supports the trial court's decision. In that case the petitioner was a corporation engaged in the distribution of water, its income arising from the sale of water. All of petitioner's stock was owned by the Regents of the University of California, a political subdivision of that State. In denying an exemption under section 116(d) the court states (p. 977):

> "The Board found: 'During 1933 petitioner did not declare any dividends, and, consequently, no income was received by the University from petitioner.' Thus it is clear that, in 1933, no part of petitioner's income accrued to Regents. For, although Regents was petitioner's sole stockholder, petitioner's income was not Regents' income and did not accrue to Regents until a dividend payable therefrom was declared by petitioner. * * *
>
> "The Board properly refused to disregard the existence of petitioner as an entity separate and apart from Regents, or it did not appear that petitioner was Regents' alter ego, or that to recognize petitioner's separate existence would promote fraud, defeat justice or produce inequitable results. * * *"

This court had occasion to consider section 116(d) in *Citizens Water Co.* v. *Commissioner*, 87 F. 2d 874. There the city owned part of the stock of the Citizens Water Co.,

an Iowa corporation for pecuniary profit, and had certain rights pertaining to the management of said company. Dividends at fixed rates were to be paid upon outstanding stock. The city had a right to compel retirement of stock out of surplus earnings. Upon repayment of the stockholders' investment at par, plus accrued and unpaid dividends, and the assumption of the duties and obligations of the corporation, the city was entitled to take over the property. The corporation sought a refund of the income tax paid. In answer to a challenge upon the constitutionality of the tax on the income of the corporation, this court held that the right of the city to direct the use of the surplus funds and the other rights conferred upon the city fell far short of ownership, and that the constitutional right existed to tax the corporate income of the water company. Relative to the interpretation of section 116(d), the court states (p. 878):

> "* * * The contention here is that the act exempts the entire income, including that going to the stockholders.
>
> "It is unnecessary here to construe section 116(d) further than to determine that the section very clearly expresses the limitation that only the income accruing to the city is exempt and that the income going to private parties is not."

The right, if any, on the part of the city to a refund under section 116(d) (1) was not reached for adjudication.

City of Burlington v. *United States*, 8 Cir., 148 F. 2d 887, arises out of the same facts as the case last discussed and involves an effort on the part of the city to recover all income taxes paid by Citizens Water Co., except for tax paid on that part of income paid as dividends to private stockholders. Such claim is made pursuant to section 116(d) (1) which varies somewhat from section

116(d), but permits a recovery only on that part of the income that accrues directly to or for the use of a political subdivision. This court denied relief, stating (p. 890):

> "This statute is applicable only if 'a part of such proceeds for the taxable year would accrue directly to or for the use of' the City. Section 116(d) (1). Since, as has been determined, no earnings of the company (except dividends) accrued directly to or for the use of the City, it follows that this statute does not apply.
>
> "The *City of Galveston* case, supra, is distinguishable in that there the claim for refund under Section 116(d) (1) was based upon the accrual of income to the City from ownership of property and not merely stockholding. See *Bear Gulch Water Co.* v. *Commissioner of Internal Revenue*, 9 Cir., 116 F. 2d 975, wherein the entire stock of the utility was owned by a state university and the court held that no income was received by the university, since although the university was sole stockholder, the corporation's income was not the university's income."

Plaintiffs assert that in the *Bear Gulch* and the *Burlington* cases, hereinabove discussed, the legislative history of section 116(d) was not adequately considered. At the invitation of the court, both parties have filed supplemental briefs discussing the consideration given the legislative history of section 116(d) in the *Bear Gulch* and *Burlington* cases.

We have examined the claims of the respective parties relating to the legislative history of section 116(d) and find nothing substantial in such history to support the plaintiffs' construction of the word "accruing." Plaintiffs urge the fact that Article 68 of Treasury Regulations 33, Revised 1918, provides that among the corporations

exempt from tax without condition are public utilities whose income inures to the benefit of any State, Territory, or political subdivision thereof. Plaintiffs stress that in the 1918 Regulations the word "inures" is used rather than "accrues." However, such regulation remained in effect only one year, and similar language does not appear in either prior or subsequent regulations. The transaction here involved arose long after the 1918 Regulations had been superseded. The fact that the 1918 Regulations used the word "inures" has little bearing upon the construction of the statute. Plaintiff sets out the following definitions of the word "accrue" from Webster's New International Dictionary, Second Edition:

> "1. *Law.* To come into existence as an enforceable claim; to vest as a right; as, a cause of action has *accrued* when the right to sue has become vested.
> "2. To come by way of increase or advantage; also, to arise or spring as a growth or result;—usually with to; as, advantages accruing to society from the freedom of the press."

Plaintiffs urge that Congress had in mind definition No. 2 set out above. We do not agree. It seems more reasonable to us that in framing statutes Congress had in mind definition No. 1 above, the legal definition of the word "accrue." The cases hereinabove cited strongly support such a conclusion.

Moreover, section 116(d) grants an exemption, and as a general rule statutes granting exemptions are to be strictly construed. *United States* v. *Stewart,* 311 U. S. 60, 71; *Omaha Public Power District* v. *O'Malley, supra.*

No dividend was paid by Western Iowa during the period involved in this litigation, nor was any such dividend declared. Consequently, Omaha District acquired no vested right or enforceable claim with reference to

any of the income earned by Western Iowa during the period here involved. No part of the income of Western Iowa accrued to Omaha District.

The defendant, as an additional reason for affirmance, urges that a corporation is an entity entirely separate and distinct from its stockholders. This issue was fully considered by this court in *Omaha Public Power District* v. *O'Malley, supra.* That case involves the identical corporate structure that we are considering here. An excise tax exemption was sought. The question considered was whether Western Iowa was publicly owned. This court held that it was not, quoting from *Moline Properties, Inc.* v. *Commissioner*, 319 U. S. 436, 438-439, as follows:

> "The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. [Cases Cited.] In *Burnet* v. *Commonwealth Improvement Co.*, 287 U.S. 415, this Court appraised the relation between a corporation and its sole stockholder and held taxable to the corporation a profit on a sale to its stockholder. This was because the taxpayer had adopted the corporate form for purposes of his own. The choice of the advantages of incorporation to do business, it was held, required the acceptances of the tax disadvantages."

During the period involved in our present case, Western Iowa was operating as an ordinary business corporation for the purpose of making profits. It was an entity entirely separate and distinct from its sole stockholder,

Omaha Electric Committee, and the beneficial owner of its stock, Omaha District. As a profit-making corporation, Western Iowa must bear its tax burden. The stipulation of the parties provides in part:

> "* * * If during any of said periods the net income of Western Iowa was not exempt from tax under said section [116(d)], none of the plaintiffs is entitled to a refund of any portion of the amounts of Federal income tax or interest paid for any period in which such net income was not so exempt."

We are convinced that the income of Western Iowa was not exempt from federal income taxation. It cannot possibly be demonstrated that Western Iowa was a political subdivision of any State. The corporation was an entirely separate and distinct entity from its stockholder.

The judgment appealed from is affirmed.

AUG 4 1998
Clerk

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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 230

OMAHA PUBLIC POWER DISTRICT, A PUBLIC CORPORATION AND POLITICAL SUBDIVISION OF THE STATE OF NEBRASKA, WESTERN IOWA POWER COMPANY, A CORPORATION, IOWA POWER AND LIGHT COMPANY, A CORPORATION, AND OMAHA ELECTRIC COMMITTEE, INC., A CORPORATION, PETITIONERS

v.

GEORGE W. O'MALLEY, COLLECTOR OF INTERNAL REVENUE FOR THE UNITED STATES INTERNAL REVENUE COLLECTION DISTRICT OF NEBRASKA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the District Court (R. 80–82) is not officially reported. The opinion of the Court of Appeals (Pet. 27–36) is reported at 232 F. 2d 805.

JURISDICTION

The judgment of the Court of Appeals was entered on May 3, 1956. The petition for a writ of

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certiorari was filed on July 5, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether the income of Western Iowa Power Company, a public utility organized for profit and operating in the State of Iowa, earned during the period from December 2, 1946, to May 14, 1949, was exempt from federal income tax under Section 116 (d) of the Internal Revenue Code of 1939 as income derived from a public utility and accruing to a political subdivision of the State of Nebraska.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 116. EXCLUSIONS FROM GROSS INCOME.
>
> In addition to the items specified in section 22 (b), the following items shall not be included in gross income and shall be exempt from taxation under this chapter:
>
> * * * * *
>
> (d) *Income of States, Municipalities, Etc.*— Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.
>
> Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract

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with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility—

(1) If by the terms of such contract the tax imposed by this chapter is to be paid out of the proceeds from the operation of such public utility, prior to any division of such proceeds between the person and the State, Territory, political subdivision, or the District of Columbia, and if, but for the imposition of the tax imposed by this chapter, a part of such proceeds for the taxable year would accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then a tax upon the net income from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this chapter, but there shall be refunded to such State, Territory, political subdivision, or the District of Columbia (under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary) an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this chapter) would have accrued directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, bears to the amount of the net income from the operation of such public utility for such taxable year.

(2) If by the terms of such contract no part of the proceeds from the operation

of the public utility for the taxable year would, irrespective of the tax imposed by this chapter, accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then the tax upon the net income of such person from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this chapter.

* * * * *

(26 U. S. C. 1952 ed., Sec. 116.)

STATEMENT

The material facts as stipulated by the parties (R. 54–80), and as adopted by the District Court (R. 81) and the Court of Appeals (Pet. 28–30), may be summarized as follows:

Pending enabling legislation and a legal test of its validity, certain citizens of Omaha, Nebraska, interested in placing the Omaha utilities under local public ownership organized, in 1944, the Omaha Electric Committee, Inc., a nonprofit Nebraska corporation. (R. 59, 63; Pet. 29.) In a series of transactions entered into on December 26, 1944, the Electric Committee acquired all of the capital stock of the Nebraska Power Company, a private corporation which owned and operated electric and power plants and a distribution system furnishing electrical energy to the city of Omaha, Nebraska, and its surrounding territory, and to the city of Council Bluffs, Iowa, and its environs. (R. 56; Pet. 29.) At the same time, the Electric Committee pledged that its acquisition

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of the common stock of Nebraska Power was for the sole purpose of transferring without profit the latter's properties to a public agency of the State of Nebraska. (R. 64; Pet. 29.)

On August 29, 1945, the Omaha Public Power District, a political subdivision of the State of Nebraska, was organized to acquire and operate facilities for generating, transmitting, and distributing electrical energy in eastern Nebraska. (R. 65–66; Pet. 29.)[1] A decree upholding its legality was entered in 1946. (Pet. 29.)

On the basis of a decision of the Supreme Court of Nebraska (*State, ex rel. Johnson* v. *Consumers Public Power District*, 143 Neb. 753), it was considered that a public power district of the State of Nebraska was without authority to engage in the business of distributing and selling power outside of the state. Accordingly, it was decided to set aside, in a separate corporation, the Iowa properties of Nebraska Power. The Electric Committee and Omaha District entered into an agreement in October 1946, which provided that the Electric Committee would organize an Iowa corporation, transfer to it a portion of the stock of Nebraska Power, and thereafter cause the Iowa properties of Nebraska Power to be distributed to the Iowa company in partial liquidation of Nebraska Power. The Electric Committee also agreed that it would sell Omaha District the remaining stock of Nebraska Power, *i. e.*, the stock representing the Nebraska

[1] The stipulation between the parties (R. 54–80), sets out in detail the long and complicated history of the creation of Omaha District and its acquisition of property.

properties. Finally, the Electric Committee agreed that it would seek to sell off the Iowa assets and that, upon doing so, it would transfer the proceeds, less the Committee's liabilities, to Omaha District. (R. 66; Pet. 29, 30.)

Pursuant to this agreement, Western Iowa Power Company, a private, profit-making utility corporation, was organized under Iowa law in November 1946, the Electric Committee purchasing all of its authorized stock. On December 1 and 2, 1946, Omaha District issued its bonds and used the proceeds to purchase the shares of Nebraska Power held by the Electric Committee. At the same time, the Iowa properties of Nebraska Power were transferred by the Electric Committee to Western Iowa in return for Western Iowa's bonds. The Electric Committee entered into an agreement with Omaha District which acknowledged that the District was the owner of, and entitled to, the beneficial interest in the assets of the Electric Committee, including the proceeds of sale of the securities of Western Iowa which were then owned by the Electric Committee. (R. 66–72; Pet. 30.)

Between December 2, 1946, and May 14, 1949, the Electric Committee owned the stocks and bonds of Western Iowa. In February, 1949, the Electric Committee entered into an agreement to sell all of the stocks and bonds of Western Iowa to Iowa Power and Light Company. In accordance with this agreement, Western Iowa transferred, in May, 1949, all of its assets, save for its claims for refund of federal taxes, to Iowa Power. (R. 72–73; Pet. 30.) It was agreed by Western Iowa that its claims for refund of

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taxes would be held in trust for the benefit of the Electric Committee and Omaha District. In July, 1949, the Electric Committee transferred to Omaha District all of its assets. (R. 75–76; Pet. 30.)

During the period from December 2, 1946, to May 14, 1949, Western Iowa operated the Iowa utilities and had income therefrom of $595,952.99, but paid no dividends. Over the same period, it paid a total of $315,302.04 in interest on its bonds to the Electric Committee, which amount was deducted prior to the determination of its income. (R. 76–79; Pet. 30.)

Claims for refund of income taxes paid by Western Iowa during the period from December 2, 1946, to May 14, 1949, were filed by Western Iowa, Iowa Power, Omaha District and the Electric Committee upon the ground that the income of Western Iowa was income accruing to Omaha District and was exempt from income tax under Section 116 (d) of the 1939 Code. These claims were disallowed by the Commissioner who ruled that the income was taxable to Western Iowa. (R. 1–48, 77–78.) The District Court upheld the Commissioner (R. 81–82), and the Court of Appeals affirmed. (Pet. 27–36.)

ARGUMENT

1. The courts below held that the income of Western Iowa, having been retained by that company and not declared or paid out as dividends, did not accrue to the Electric Committee (Western Iowa's sole stockholder during the relevant period) or to the Omaha District on whose behalf the Committee had agreed to act. We believe that this holding is clearly correct.

There is no reason to suppose that Congress used the word "accruing," as it appears in Section 116 (d), in a sense other than that in which it is customarily used in the revenue laws. One "accrues" income, in the accepted sense, only if one has a vested right or an enforceable claim to it. Neither the Electric Committee nor the District had such a right or claim. A shareholder in a corporation has "no immediate individual right in corporate profits, but a right which accrues only if and to the extent that a dividend is declared out of profits." Stevens, *Corporations*, § 99 (1936). "Money earned by a corporation remains the property of the corporation, and does not become the property of the stockholders, unless and until it is distributed among them by the corporation. The corporation may treat it and deal with it either as profits of its business, or as an addition to its capital." *Gibbons* v. *Mahon*, 136 U. S. 549, 558.

The Court of Appeals correctly noted that there is no support in the legislative history for petitioners' effort to read the word "accrue" in the sense of "inure to the benefit of" (Pet. 33–34). As one of the managers of the legislation, Senator Shively explained when the language in question (in an earlier revenue act) was under consideration by the Senate (50 Cong. Rec., Part 6, pp. 5320–5321):

> It seems to me, as the text refers to income and then says "accruing," that it can exempt only such income as goes to the municipality and can exempt nothing else.
>
> * * * * *
>
> The fact is that we were trying to draw the line sharply between the revenue derived by

the corporation from its business and the revenue derived by the Government from the corporation.[2]

In construing "accruing" in its usual tax sense, the decision below is also in full agreement with the other cases involving the application of Section 116(d) to comparable factual situations. *Citizens Water Co.* v. *Commissioner*, 87 F. 2d 874 (C. A. 8th), certiorari denied, 302 U. S. 694; *Bear Gulch Water Co.* v. *Commissioner*, 116 F. 2d 975 (C. A. 9th), certiorari denied, 314 U. S. 652; *City of Burlington* v. *United States*, 148 F. 2d 887 (C. A. 8th); *Town of Fairhaven, Mass.* v. *United States*, decided July 12, 1956 (C. Cls.) (Appendix, *infra*, pp. 15–23). See, also, *Philadelphia Rapid Transit Co.* v. *United States*, 8 F. Supp. 152 (E. D. Pa.).

There is no merit to petitioners' contention (Pet. 18–20) that the decision below is in conflict with the contemporaneous administrative construction of the statute. The fact that Article 68 of Treasury Regulations 33 (1918 ed.) used the word "inures" rather than "accrues" scarcely shows an intent by the Service to cover accumulated as well as distributed income. In any event, as the Court of Appeals pointed out (Pet. 33, 34), the regulation was not a contemporaneous interpretation of the statute, but was promulgated in 1918, five years after the statute had been first enacted, and remained in effect for only one year. Furthermore, the term "inures" does

[2] Section 116 (d) of the 1939 Code is derived from Section II G (a) of the Income Tax Act of 1913, c. 16, 38 Stat. 114, 166, and the relevant history is found in connection with the enactment of the 1913 statute.

not appear in any prior or subsequent Treasury Regulations which interpreted this statutory provision,[3] or in any re-enactment of the statute, including Section 115 of the 1954 Code. (26 U. S. C., 1952 ed., Supp. III, Sec. 115.) The omission of the term "inures" from subsequent regulations, despite the continued re-enactment of the statute, takes from petitioners' argument any force that it might otherwise have. See *Helvering* v. *Reynolds*, 313 U. S. 428.[4]

2. There is a sound independent basis for sustaining the result reached below. For even were one to assume, *arguendo*, that the income in question accrued to Omaha District, it would not follow that such income was derived from a public utility operation within the meaning of Section 116 (d). As its language indicates and as its history confirms, Section 116 (d) was designed to make absolutely clear that the states and their political subdivisions would not be taxed on income received by them in connection with the performance of essential governmental functions. It appears further that Congress included a reference to income from public utility operations,

[3] Treasury Regulations 33 (1914 ed.), Article 93; Treasury Regulations 45 (1919 ed.), Article 84; Treasury Regulations 45 (1920 ed.), Article 84; Treasury Regulations 62 (1921), Article 87; Treasury Regulations 65 (1924), Article 87; Treasury Regulations 69 (1926), Article 87; Treasury Regulations 74 (1929 ed.), Article 642; Treasury Regulations 74 (1931 ed.), Article 642; Treasury Regulations 77 (1932), Article 642.

[4] Neither O. D. 328, 1 Cum. Bull. 93 (1919), nor Rev. Rul. 54–296, 1954–2 Cum. Bull. 59, cited by taxpayer (Pet. 21–23), is applicable herein, whereas S. M. 2941, IV–1 Cum. Bull. 210 (1925), and G. C. M. 14407, XIV–1 Cum. Bull. 103 (1935), cited by taxpayer (Pet. 21–22), support the position taken by the Collector in this case.

in addition to specifying income derived from "any essential governmental function", merely to avoid dispute as to whether public utility activities, when undertaken by a state or municipality for its citizens, should be considered governmental, rather than commercial, for purposes of the federal taxing statute.

The Statement of the Managers on the Part of the House setting forth the recommendations of the Conference Report (H. Conf. Rep. No. 86, 63d Cong., 1st Sess., p. 2 (1939–1 Cum. Bull. (Part 2) 6, 7; 50 Cong. Record, Part 6, p. 5229)) pointed out:

> The House provision which only exempted profits accruing to States and their political subdivisions from the operation of their essential governmental agencies is modified to the extent that all such profits accruing from public utilities shall also be exempt.

Senator Shively, explaining the recommendations of the conferees to the Senate, stated that the Finance Committee had been advised of "several cases wherein it seemed that there are derived from public utilities and going to municipalities certain incomes that should be exempt" (50 Cong. Rec., Part 6, p. 5320). He added (*ibid.*). "We did not care to appear, so far as the taxing authority could do so, to authorize the State or municipality to go into all kinds of private business and have their income exempted. The words 'essential governmental function' were used as a limitation."

With this limitation in mind, it seems plain that the instant case does not fall within the purpose and

scope of the exemption provision. By no stretch of imagination can the operations of Western Iowa be deemed an essential function of Omaha District. Indeed, the very reason for organizing Western Iowa was to separate the Iowa properties from the Nebraska properties preliminary to conveying the latter to the District. And that was undertaken because the District itself believed that it was without any authority to conduct out-of-state utility operations. Certainly, then, there can be no argument on the proposition that public utility operations in Iowa do not qualify as a governmental function of a political subdivision of Nebraska.

3. Neither of the two cases upon which taxpayer relies for conflict involved the question here presented.

In *Jamestown & Newport Ferry Co.* v. *Commissioner,* 41 F. 2d 920, the First Circuit's decision was based largely upon constitutional theory which has since been rejected by this Court. Cf. *Helvering* v. *Powers,* 293 U. S. 214; *New York* v. *United States,* 326 U. S. 572. See 50 Cong. Rec., Part 6, p. 5320. The First Circuit held that, independently of the statutory exemption, the ferry company, as a public utility substantially owned by a municipality and essential to the normal life of the community, was constitutionally exempt from federal taxation. Accordingly, that court sought to construe the statute so as to import an intent by Congress not to levy any taxes upon the utility. The Eighth Circuit, however, in *Citizens Water Co., supra,* 87 F. 2d at 877, correctly distinguished the *Ferry Co.* case as involv-

ing a corporation not "privately organized but controlled and practically owned by the city and not really operated for profit."

In the present case, the District was not even a stockholder of Western Iowa and it had no control over Western Iowa's operations. Western Iowa was not essential to the existence of the District and, in fact, serviced an area in which the District was not authorized to operate. Also, Western Iowa was operated for profit in the same manner as any other private enterprise. Accordingly, the court below was correct in holding (Pet. 35–36) that Western Iowa was more than a mere *alter ego* or instrumentality of the District. *Moline Properties* v. *Commissioner,* 319 U. S. 436; *National Carbide Corp.* v. *Commissioner,* 336 U. S. 422; *United States* v. *Joliet & Chicago R. Co.,* 315 U. S. 44; *Omaha Public Power District* v. *O'Malley,* 216 F. 2d 764 (C. A. 8th).

Nor is the decision in *City of Galveston, Tex.* v. *United States,* 10 F. Supp. 810 (C. Cls.), certiorari denied, 297 U. S. 712, relevant. In that case, the Court of Claims found, in substance, that there was a contractual arrangement between the city and a wharf company; that the city actually owned one-third of the wharf property; that if the wharf company had not paid the income tax the dividends to the city would have been increased; and, finally, that the city had a contract right to its share of the wharf company's profits. The court below distinguished the *Galveston* case on the ground that the claim for refund in that case "was based upon the accrual of income to the City from ownership of property and not

merely stockholding." Furthermore, the fact that the Court of Claims, in its very recent opinion in *Town of Fairhaven, Mass.* v. *United States*, decided July 12, 1956 (Appendix, *infra*, pp. 15–23), made no mention of its earlier *Galveston* decision, but relied upon the decision in the instant case, shows that there is no basis for asserting a conflict as between the Eighth Circuit and the Court of Claims.

CONCLUSION

The decision below is correct and there is no conflict. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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AUGUST 1956.

APPENDIX

IN THE UNITED STATES COURT OF CLAIMS

No. 8–54

(Decided July 12, 1956)

THE TOWN OF FAIRHAVEN, MASS., THE MILLICENT LIBRARY AND THE FAIRHAVEN WATER COMPANY v. THE UNITED STATES

Mr. Allen G. Gartner for the plaintiffs.

Mr. Gilbert E. Andrews, with whom was *Mr. Assistant Attorney General Charles K. Rice,* for the defendant. *Mr. Andrew D. Sharpe* was on the brief.

LITTLETON, *Judge,* delivered the opinion of the court:

The plaintiffs[1] brought this suit to recover Federal income taxes paid by the Fairhaven Water Company for the years 1945, 1946, 1947, 1948, and 1950, under the provisions of section 116 (d) of the Internal Revenue Code of 1939, as amended. 26 U. S. C. § 116 (d).

The facts as found by the commissioner of this court are not in dispute. The Town of Fairhaven, Massachusetts (hereinafter referred to as the Town), is a municipal corporation established by an act of the Massachusetts Legislature on February 22, 1812.

[1] The plaintiffs are the Town of Fairhaven, Mass., the Millicent Library and the Fairhaven Water Company. By agreement of the parties, the claim presented in this action is limited to the issues of law and fact relating to the right of the Town of Fairhaven to recover.

The government of the Town consists of a limited form of the New England Town Meeting. The Millicent Library (hereinafter referred to as the Library), was incorporated on December 1, 1892, under a law of Massachusetts pertaining to the incorporation of religious and other nonprofit organizations. The charter of the Library stated that the purpose for which it was organized was the "establishment and maintenance of a Library." Since it opened, the Library has been operated as a free, public library. The Fairhaven Water Company (hereinafter referred to as the Water Company), was organized in 1888 under the laws of Massachusetts pertaining to corporations organized for pecuniary profit. The purpose for which it was formed was to supply the inhabitants of the Town with water for domestic, manufacturing and other purposes, including the extinguishing of fires.

Henry H. Rogers, a native of the Town and a multimillionaire, was the principal benefactor of the Town. His gifts to the Town and its inhabitants included the Millicent Library, the Fairhaven High School, the Town Hall, the Rogers Grammar School, the Unitarian Memorial Church, and Cushman Park. Henry H. Rogers and his wife conveyed in trust a plot of land and the building situated thereon to their surviving children who, by deed of gift dated December 1, 1892, conveyed the property to the inhabitants of the Town. The deed read in pertinent part as follows:

> * * * whereas it is the purpose and intent of these grantors in making this conveyance to give to the Inhabitants of the Town of Fairhaven a Free Public Library as a memorial of our sister Millicent G. Rogers; and whereas a building appropriate to the uses of such a Library has now been erected on said land,

> and our wish is that said building shall forever remain as at present built without enlargement or alteration; and whereas it is also our purpose and design that the Inhabitants of Fairhaven, as a municipal corporation, shall be under no obligation whatever to support or maintain said library; * * *.

On May 22, 1893, Henry H. Rogers established a trust fund of $100,000 with the State of Massachusetts for the support of the Library. The State authorized the treasurer of the Commonwealth to receive and invest the $100,000 and to pay the annual income therefrom to the Library. During the years in suit, the Library annually received the sum of $2,500 from the trust.

In 1901, all the capital stock of the Water Company was given to the Library by Mr. Rogers. It was a matter of common knowledge in the Town that Mr. Rogers made the gift of the stock to the Library for its support.

The care, management, and control of the Library is vested in a board of 15 trustees, 12 of whom are required to be inhabitants of the Town. All the trustees serve without compensation for life, and vacancies on the board are filled by a vote of two-thirds of the remaining members. Prior to February 11, 1949, no officer of the Town was, by virtue of his office, an officer or trustee in the Library. In conducting its activities, the Library has endeavored to provide the entire community the best library services that were possible with the available resources. In addition to the central library, it has maintained six branch libraries and provided collections of books for supplementary reading in the schools. Since 1929, the Library has carried on a special program consisting of story hours and moving pictures for children. In 1950, the book stock of the

Library consisted of 46,611 volumes and the circulation of its book per capita was 4.95. The Library from 1892, until the latter part of 1948, was supported by the income from the trust fund established by Henry H. Rogers, by a small amount of miscellaneous gifts and donations and by dividends which the Library received as sole owner of the stock of the Water Company. These dividends provided the major portion of the funds used for the operation of the Library.

Since its incorporation in 1888, the business of the Water Company has been conducted by a board of directors, including three officers, who are elected annually by the stockholders. The Water Company is regulated by the Massachusetts Department of Public Utilities and may not increase its rates except on application to and approval by the Department of Public Utilities. A substantial portion of the profits of the Water Company were distributed to the Library for its support.

In 1948, it became apparent that either the services of the Library would have to be curtailed or the Town would have to furnish financial aid. The question was presented to the Town Meeting on December 8, 1948, and it was unanimously voted to appropriate $4,000 to assist in paying the expenses of the Library for the year ending December 31, 1948. Similar appeals were made in subsequent years, and the Town made further appropriations for the Library in the amounts of $11,182 for 1949, and $11,716 for 1950. These annual appropriations were considered and acted upon in the same manner as appropriations for any department of the Town. An officer of the Town was made an ex officio member of the Board of Trustees of the Library in 1948 and continued as

such thereafter as long as the Town appropriated money for the support of the Library.

The Town has never had any voice in the affairs of the Water Company. The Water Company charges the Town for all water used by it and the Water Company pays real estate, personal property and franchise taxes to the Town. The Water Company also pays taxes to the State and to the Town of Mattapoisett, Massachusetts.

The annual net income of the Water Company, as reported in its income and excess profits tax returns for the years involved here, the amount of Federal taxes paid, and the dates paid are shown in finding 19. The dividends paid by the Water Company to the Library during each of the years in suit were not deducted from the gross income of the Water Company before computing the amount of income tax due.

The Town filed with the Commissioner of Internal Revenue claims for refunds of the income taxes paid by the Water Company for 1945 on October 31, 1951, and for 1946, 1947, 1948, and 1950 on November 28, 1951. Suit in this court was filed on January 8, 1954. The claims for refunds were formally rejected on January 9, 1954.

Section 116 (d) provides:

> In addition to the items specified in section 22 (b), the following items shall not be included in gross income and shall be exempt from taxation under this chapter: * * *
>
> (d) *Income of States, municipalities, etc.*—Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the government of any possession of the United States, or any political subdivision thereof.

> Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility—
>
> (1) If by the terms of such contract the tax imposed by this chapter is to be paid out of the proceeds from the operation of such public utility, prior to any division of such proceeds between the person and the State, Territory, political subdivision, or the District of Columbia, and if, but for the imposition of the tax imposed by this chapter, a part of such proceeds for the taxable year would accrue directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, then a tax upon the net income from the operation of such public utility shall be levied, assessed, collected, and paid in the manner and at the rates prescribed in this chapter, but there shall be refunded to such State, Territory, political subdivision, or the District of Columbia (under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary) an amount which bears the same relation to the amount of the tax as the amount which (but for the imposition of the tax imposed by this chapter) would have accrued directly to or for the use of such State, Territory, political subdivision, or the District of Columbia, bears to the amount of the net income from the operation of such public utility for such taxable year.

The Town contends that it is entitled to recover all the income taxes paid by the Water Company for the years involved in this proceeding. It contends in the alternative that it is entitled to recover a proportionate part of the taxes determined pursuant to paragraph (1) of section 116 (d). The Town predi-

cates both arguments on the assumption that it, as a political subdivision within the meaning of section 116 (d), was and is the owner, beneficially at least, of the Library, which in turn owns all the stock of the Water Company. However, the Town, as a municipal corporation and political subdivision, is not the legal or equitable owner of the Library. The Library was given in trust to the "Inhabitants of Fairhaven" and not to the Town as a municipal corporation. The deed of conveyance provided "the Inhabitants of Fairhaven, as a municipal corporation, shall be under no obligation whatever to support or maintain said library." The Library was a separate non-profit corporation, directed and managed by a self-sustaining board of trustees. The Town, as a municipal corporation, had no control over the Library before it started contributing to its support. After it started contributing to the support of the Library it had only one ex officio member on the board of trustees. The inhabitants of the Town have no direct control over the Library. The inhabitants of the Town, the Town, the Library and the Water Company are all separate legal entities.

The Town contends that these separate legal entities should be ignored and that what it calls substance should prevail over form. The general rule in Federal taxation is, of course, that the corporation must be considered an entity separate and distinct from its stockholders. *Moline Properties, Inc.* v. *Commissioner*, 319 U. S. 436, and the cases cited therein. The exception to that general rule is limited to sham transactions and situations involving transactions or matters that lack a business purpose and are a mere formality. See *Ingle Coal Corporation* v. *United States*, 131 C. Cls. 121, cert. denied 350 U. S. 842, and the cases cited therein. There

is, of course, no sham transaction involved in the instant case. Also, each of the legal entities had obvious legitimate reasons for a separate legal existence and many legal consequences flow therefrom, thus making the separate existence more than a mere formality.

The majority of the courts that have interpreted section 116 (d) have held that the political subdivision must be considered a separate legal entity from the business corporation that it owned and had an interest in, and have refused to exempt the income of the corporation from taxation. *Omaha Public Power District, a public corporation and political subdivision of the State of Nebraska, et al.* v. *O'Malley*, Docket No. 15,425, (decided May 3, 1956), Eighth Circuit United States Court of Appeals; *City of Burlington* v. *United States*, 148 F. 2d 887; *Bear Gulch Water Co.* v. *Commissioner*, 116 F. 2d 975, cert. denied 314 U. S. 652; *Citizens Water Co.* v. *Commissioner*, 87 F. 2d 874, cert. denied 302 U. S. 694. Contra, *Keokuk & Hamilton Bridge, Inc.* v. *Commissioner*, 180 F. 2d 58. It is clear from the above cases that the Inhabitants of the Town, the Town, the Library and the Water Company are separate legal entities, and as such, the first sentence of section 116 (d) has no application because no income of the Water Company accrued to the Town as a political subdivision. The income of the Water Company, to the extent of the dividends, may have "accrued" to the Library; however, it cannot be said that it "accrued" to the Town. The benefit received by the Town was the indirect relief of a general obligation to furnish its inhabitants with an adequate library. The Town, therefore, is not entitled to recover the taxes paid by the Water Company.

Nor is the Town entitled to recover any of the taxes paid by the Water Company on its alternative ground for the same reason. The Town does not own or control the Library and, of course, does not have a contract with the Water Company and therefore does not come within the terms of paragraph (1) of section 116 (d). The right to recover, if any, of the remaining parties in this case has not been considered since it is apparent that they have abandoned their claims. The Town of Fairhaven is not entitled to recover and therefore the plaintiffs' petition is dismissed.

It is so ordered.

LARAMORE, *Judge*; MADDEN, *Judge*; WHITAKER, *Judge*; and JONES, *Chief Judge*, concur.